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RESPECTIVE RIGHTS OF PREFERRED AND COMMON STOCKHOLDERS IN SURPLUS PROFITS

THE movement in the field of coöperative commercial undertakings has been, school-book-like, a movement from the simple to the complex, from the common-law situation of persons associating together to conduct a business for profit to the modern statutory association and the corporation possessing an enormous capital derived from a host of individuals whose respective interests are represented by various classes of transferable shares.

Of course, the real incentive of the individual member of such a group is to share in the increased profits secured by mobilization of capital, with the resultant efficiency of the large scale enterprise over such small undertakings as his limited means could finance. Usually, therefore, he seeks to protect his interest in the profits of the concern by express contract, but with characteristic businessman confidence in the other fellow, he often employs very general terms and relies upon trade usages and the market-place sense of fair play to cover the details.

He is, moreover, prone to assume that what is law among business men in their dealings with each other, and in reliance upon which they daily pay out large sums of money in purchase or settlement, is also law in the courts. Unfortunately, the law merchant and the common law have never yet been on all fours with each other, and perhaps they never will precisely coincide, since it is the peculiar function of the law merchant to be always reaching out to control the latest developments in the commercial field, while the common law must needs await the definite crystallization of the mercantile

usage upon a particular point before it can in justice add its sanction.¹

In this instance, however, the business view and the legal doctrine seems to have been in accord to the extent, at least, that both regarded the rights of the respective classes of stockholders *inter sese* as governed by the statute of incorporation, or by the contract, expressed or implied in fact, under which the preferred stock was issued.² It is worthy of note that, although for upwards of seventy years³ classification of corporate stock has been a common thing, and the rights of the various classes with respect to each other have been the substance of everyday business transactions in the issue and sale of preferred and common shares and payment of dividends thereon, yet business men have felt so confident of the interpretation given those rights by the generally accepted mercantile usage that resort to the courts has been rare indeed. In consequence, we find few cases even indirectly involving our subject, either in England or America, prior to the opening years of the twentieth century.

The implied contract of equality of shares in the simple corporate situation with its one class of stock is now accepted as a matter of course, but when our specific problem is presented with its diversified classes of stock, one having priority over another in division of profits, capital, or otherwise, then, as we have seen, the statute or

¹ See Dean Pound's address, "Commerce and Legal Progress," delivered before the Commercial Law League, July, 1917, in which he points out how commerce has in the past opened up the path of progress for the law. 28 AMERICAN LEGAL NEWS, October, 1917; Commercial Law League of America, Bulletin 1, XXII (1917), 608.

² Recent cases stating this settled view are: *Paterson v. R. Paterson & Sons, Ltd.* (House of Lords), 1917, 54 Scot. L. Rep. 19; *Speare v. Rockland-Rockport Lime Company*, 113 Me. 285, 93 Atl. 754 (1915); *In re National Telephone Company*, [1914] 1 Ch. 755; *Bassett v. U. S. Cast Iron Pipe & Foundry Co.*, 74 N. J. Eq. 668, 673, 70 Atl. 929 (1908).

³ *Everhart v. West Chester, etc.*, R. R., 28 Pa. St. 339 (1857); *Henry v. Great Northern Ry. Co.*, 1 De. G. & J. 606 (1857).

See New York Act, March 29, 1848 (P. L. 238), empowering the New York & Harlem R. Co., to issue preferred stock; Pennsylvania Act, March 4, 1850 (P. L. 129), authorizing the Beaver Meadow Railroad & Coal Company to issue preferred stock which was to be entitled to preference over all other stock of said company in future dividends of profits; New Jersey General Corporation Act, March 22, 1860 (P. L. 603), first providing in that state for the issue of special preferred stock.

contract creating such classification becomes the dominant factor in determining the respective rights of the different groups of stockholders.⁴

The very fact that our problem is essentially one of statutory construction and interpretation of contracts has led some authorities to belittle it as a matter of general legal interest,⁵ and probably accounts for the off-hand manner in which the text-writers have treated it, if, indeed, they touch upon it at all.⁶ On the other hand, seldom are the courts called upon to decide a matter of such widespread significance to the business world, one in which frequently the division of millions of dollars is at stake, and furthermore, we have the statement of one of our most scholarly federal judges that this is a field in which authoritative legal writing is much needed.⁷

That we may have a definite conception of the scope of our subject, it must be emphasized that this discussion is limited to the specific problem of the respective rights of the typical classes of corporate stockholders—preferred and common—in the distribution of the surplus profits of a going corporation for a particular year, or in the division of an accumulated surplus of profits.⁸

⁴ Note 2, *supra*, and cases discussed, *infra*.

⁵ "My Lords, this appeal raises a question of great interest from a business point of view, but it is difficult to see how it can be said to raise any question of general legal interest. The point in dispute (our very subject) is one of construction, and construction must always depend on the terms of the particular instrument; it is only to a limited extent that other cases decided upon different documents afford any guidance." Viscount Haldane. *L. C.*, in *Will v. United Lankat Plantation Co., Ltd.*, [1914] A. C. 11, 15.

⁶ VI FLETCHER, *CYCLOPEDIA CORPORATIONS* (1919), Sec. 3755; I COOK ON *CORPORATIONS* [7th ed., 1913], Sec. 269; IV THOMPSON ON *CORPORATIONS* [2nd ed., 1909], Sec. 3603; CONYNGTON ON *CORPORATE ORGANIZATION* [1908 ed.], p. 70, same in edition of 1917, p. —; II CLARK AND MARSHALL ON *PRIVATE CORPORATIONS* (1901), Sec. 417; TAYLOR ON *CORPORATIONS* [3rd ed., 1894], Sec. 788; I MORAWETZ ON *PRIVATE CORPORATIONS* [2nd ed., 1886], Sec. 456.

⁷ "This is not the court in which it is appropriate to write an elaborate essay on the rights of preferred shareholders, although the facts presented in this brief record (relating to division of surplus profits) afford the opportunity. Such an essay, if well done and with authority, is much needed." Hough, D. J., in *Niles v. Ludlow Valve Mfg. Co.*, 196 Fed. 994 (1912).

⁸ The authorities, generally, have made a distinction between a preference in profits of a going concern and a preference in capital assets on liquidation, holding that though stock is preferred in profits that does not make it pre-

The question arises from two general types of statutes or contracts:

I. Those statutes or contracts in which the preferred shares are in express terms, or by words of necessary implication, allowed or prohibited, as the case may be, a further participation in the profits after they have received their stipulated preferential dividend.⁹

Sometimes the statute or contract provides in great detail for the rights of each class of stockholders in the distribution of profits. For example, in an English case¹⁰ the company's memorandum of association gave the preferred shares a preference dividend of seven per cent and one-fifth of any surplus profits remaining after an equal dividend had been paid to the ordinary shares. This method indicates careful and intelligent draftsmanship and is to be highly commended.

Very often the terminology is not so definite and certain as the above, and the courts are forced to resort to the various documents

ferred in assets on a winding up, but it participates equally with the common stock both as to return of capital and in division of surplus assets. In *re London India Rubber Co.*, L. R. 5 Eq. 518 (1868); *Birch v. Cropper*, 14 App. Cas. 525 (1889); *Lloyd v. Pennsylvania Electric Vehicle Co.*, 25 N. J. Eq. 263, 72 Atl. 16 (1909).

The same has been held as to distribution of capital surplus of a going corporation. *Jones v. Concord & Montreal R. R.*, 67 N. H. 119, 234 (1891). But see *In re National Telephone Co.*, [1914] 1 Ch. 755, denying to stock preferred both as to dividends and to assets, on a winding up, the right, after being repaid its par value, to participate with the common shares in distribution of surplus capital assets. Also, *Michael v. Cayey-Coquas Tobacco Co.*, 190 App. Div. 618, 180 N. Y. Supp. 532 (1920). Cf. *In re Fraser & Chalmers, Ltd.*, [1919] 2 Ch. 114.

⁹ A careful research indicates that every decision relating to the right of the preferred stockholders to share with the common stock in surplus profits in excess of their stipulated dividend prior to 1906 was of this type.

¹⁰ *Ashbury v. Watson*, 30 Chan. Div. 376, 54 L. J. Ch. (N. S.) 985 (1885). See also *Field v. Lamson & Goodnow Mfg. Co.*, 162 Mass. 388, 38 N. E. 1126 (1894), where the statute (MASS. LAWS 1885, Ch. 349, Sec. 2) expressly provided that the holders of preferred stock in the defendant corporation should "be entitled to all the privileges of other members of said corporation, including the right to vote upon such stock," and the rights of the preferred stock issued thereunder were very definitely stated, *inter alia*, "to share *pro rata* with the holders of the common stock in any excess divided in any year above a dividend on the whole stock of said company at said rate of six per cent."

making up the contract relating to the particular stock issue and the purposes they were designed to serve in order to determine the rights of the respective groups of stockholders. In *Bailey v. Hannibal & St. Joseph R. Co.*,¹¹ the preferred stock certificate stated that the holder was entitled to a preference in profits "up to \$7 per share" in each year, "and to share in any surplus beyond \$7 per share which may be divided upon the common stock." A dividend of seven per cent having been declared on the preferred and three and a half per cent on the common, a preferred shareholder sought to share equally with the common in this fund, but the court looked back to the plan of reorganization under which the bondholders surrendered their bonds for said preferred stock, and found that it specifically provided that said stock was "to share with the common stock any surplus which may be earned over and above 7 per cent upon both in any one year," and dismissed the suit.

Also, in the well-known case of *Gordon's Executors v. Richmond, etc., R. Co.*,¹² the resolution under which the preferred stock was issued provided that it should be entitled to share in all dividends paid on the common in excess of the preferred dividend, and the court accordingly admitted it to participate with the common in a script dividend representing accumulated profits used for betterments.

Then there are the opposite cases under this type in which the statute or contract prohibited any further sharing of surplus profits by the preferred stock after payment of the preferential dividend. One such case involved the cutting of an eighty-million-dollar "melon" of accumulated surplus profits, and the common stock took it all under a clause of the articles of association which, after providing for the stipulated preferred dividend, added, "but to no other or further share of the profits."¹³

These cases turn on well-settled legal principles, and perhaps their chief value to the lawyer is to impress upon him the importance of specifically covering this problem in drafting the various corporate

¹¹ 84 U. S. (17 Wall.) 96 (1872).

¹² 78 Va. 501 (1884).

¹³ *Equitable Life Assurance Society v. Union Pacific R. R. Co.*, 212 N. Y. 360, 106 N. E. 92 (1914); also, *Russell v. American Gas & Electric Co.*, 152 App. Div. (N. Y.) 136, 136 N. Y. Supp. 602 (1912).

papers relating to the classification of the stock,¹⁴ for, as we have seen, once the courts discover explicit contractual provisions they will enforce them, irrespective of the huge sums involved. They also teach a very practical lesson to both the lawyer and business man: that the purchaser of preferred stock cannot always depend upon the purported definition of his rights in the stock certificate, but in the abundance of precaution should check it up with the other documents which together contain the contract governing that stock issue.¹⁵

The other type of statute or contract might be termed the short or mercantile form, and may be described as:

II. Those statutes or contracts providing for preferred shares entitled to a specified preferential dividend before anything is paid to the common stock, but containing no provision whatever respecting its right to share in any surplus profits in excess of the stipulated dividend.

It is this second type that presents the real legal problem in solving the respective rights of preferred and common stockholders in surplus profits. Strangely enough, we have but a judicial *dictum* or two from the last century,¹⁶ and in fact the question seems to have been first directly broached in Anglo-American law in 1901, in the leading case of *Scott v. Baltimore & Ohio R. Co.*¹⁷ That case, however, as actually decided was of Type I, and it has derived its outstanding importance from the *dictum* rather than the decision

¹⁴ See suggested form in PALMER'S COMPANY PRECEDENTS, Part I [11th ed., 1912], p. 1106, Form 464 *et seq.*; V COOK ON CORPORATIONS [7th ed., 1913], p. 4044.

¹⁵ It is agreed that the terms of these contracts are to be gathered from the articles of incorporation or memorandum of association, the by-laws, minutes of corporate meetings, resolutions of the stockholders and directors, propositions or reports to the company, and agreements, conveyances, etc., pertaining to the issue of the stock in question, and classes having a preference over it. See I COOK ON CORPORATIONS [6th ed., 1908], Sec. 269.

¹⁶ In *re Bridgewater Navigation Co.*, 39 Ch. Div. 1, 11, 13 (1888); *North, J.*; *Birch v. Cropper*, 14 App. Cas. 525, 531 (1889), Lord Herschell; In *re Bridgewater Navigation Co.*, [1891] 2 Ch. 317, Lindley, L. J., where profits set apart by directors for depreciation, insurance, and improvements were held on a winding up to go to ordinary shareholders exclusively, although there were preferred shares entitled to a preferential dividend of five per cent.

¹⁷ 93 Md. 475, 49 Atl. 327 (1901).

upon the point before us. It appeared that in the reorganization of the railroad company preferred stock was issued which was entitled to an annual non-cumulative dividend "up to, but *not exceeding* four *per centum* before any dividend shall be set apart or paid upon the common stock." A preferred stockholder who had received his stipulated dividend sought to participate upon an equal footing with the common stock in the division of the remaining annual profits. The court denied his claim on the ground that the words "not exceeding" were words of limitation, measuring the maximum rights of the preferred shareholders in distribution of profits.¹⁸

Our problem as presented under Type II might conceivably be solved in any one of three ways:

(1) After payment of the agreed preferential dividend any balance of profits be divided *pari-passu* among both the preferred and common shares.

(2) Upon payment of the designated preferred dividend, a like annual dividend be paid to the common stock any profits remaining to be divided equally among both the preferred and common shareholders.

(3) When the preference dividend specified has been fully paid, the entire residue of the profits to go exclusively to the common stock.

To date no court has adopted the first of this trilogy of possible solutions as applied to the Type II situation, the conflict of the cases having centered about the respective merits of the second and third views.

For a concise statement of the legal situation as it existed in 1901 with respect to cases of Type II, we cannot do better than quote the words of Page, J., in *Scott v. Baltimore & Ohio R. Co.*¹⁹ (p. 502):

"Whatever courts may hold eventually as to the right of ordinary preferred stock²⁰ to share in the residue of net earn-

¹⁸ *Semble* *St. John v. Erie Railway Co.*, 89 U. S. (22 Wall.) 136, 147 (1874), Swayne, J.

¹⁹ See note 17, *supra*.

²⁰ The suggested distinction between "ordinary preferred stock," that is, preferred stock issued simultaneously with the common stock or in ordinary course of the corporate existence, as distinguished from such stock issued in a reorganization adjustment, seems unsound in principle, and has not been adopted in later cases.

ings after its preferred dividend has been received, the maintenance of that right, in the absence of anything in the contract creating such preferred stock, so far as we are informed, has not yet been taken by any court. No decision holding this has been furnished us by the very able and industrious counsel²¹ who argued this case for the appellant, and we have found none ourselves. It is true that some text-writers²² do intimate that such may be the law, but the cases cited are those where there is express provision for the participation in the surplus, and fall far short of sustaining the proposition by which the appellants here seek to impose the additional quality on the preferred stock. * * * So that there is no room here for the argument that in declaring the rights of the preferred stock it was not necessary to state particularly that it should have such attributes, because of the reason that under well-settled principles of law it is entitled *proprio vigore* to such participation."

The second or theoretical conception, however, succeeded in getting away to a running start, in spite of the fact that the third solution seems to have been the original and generally accepted understanding in business and financial circles.

Thus, in 1906, in the very first decision of our problem under Type II in Anglo-American law, we find the Pennsylvania Supreme Court, in *Fidelity Trust Co. v. Lehigh Valley R. Co.*,²³ upholding

²¹ The most brilliant corporation lawyers of the time appeared in this case (*inter alia*), John G. Johnson, Esq., of Philadelphia, Pa., for the appellant; William D. Guthrie, Esq., of New York City, for the appellee, and Victor Morawetz, Esq., of New York City, for certain voting trustees.

²² See I COOK ON CORPORATIONS [4th ed., 1898], Sec. 269: "It seems that unless the contract expressly provides otherwise, preferred stockholders participate in the surplus profits remaining after the proper dividend has been declared on the preferred and an equal dividend on the common stock." This statement is typical of most of the text-books of the day; *cf.*, the more conservative statement of TAYLOR ON PRIVATE CORPORATIONS [3rd ed., 1891], Sec. 788: "Aside from considerations arising from the circumstance that part of the shares are preferred, or that a part are more fully paid up than others, every shareholder is entitled, both in the distribution of profits and on the winding up of the corporation, to participate in proportion to the number of shares held by him."

²³ 215 Pa. 610, 64 Atl. 629 (1906).

the right of the preferred stock to share *pro rata* with the common in the distribution of surplus profits remaining after payment of the stipulated preference dividend, and a like annual dividend upon the common stock. There the statute under which the preferred shares were issued merely provided that they should be entitled to a dividend of ten per cent per annum before the other stock of the company should participate in any further distribution of its profits. Long before, the company had in three prosperous years paid an extra dividend of ten per cent upon both the preferred and common stock after payment of the preferential dividend and an equal dividend upon the common shares. The common stockholders claimed these extra dividends should be treated as advance payment of the stipulated preferred dividend, and should, therefore, be deducted from arrearages due to preferred stockholders for unpaid dividends. The court, however, denied the contention on the ground that the statute fixed no limitation on the rights of the preferred stock in granting it a fixed preference in dividends, "but when each class of stock had been paid ten per cent they were equal and equally entitled to partake of whatever remained in the fund applicable for dividend purposes." No authorities were cited by the court in reaching this decision. Perhaps the result may be supported upon the assumption, as appears in the case, that the two classes of stockholders interested had adopted a practical interpretation of the statute respecting their rights by acquiescing without objection in that method of distributing the surplus profits.

By a coincidence, the next case under Type II, and the one which has become the foremost champion for the second solution, also arose in Pennsylvania. This was *Sternbergh v. Brock*,²⁴ in 1909. The contract under which the preferred stock was issued provided that it should "receive a cumulative yearly dividend of five per cent, payable quarterly * * * before any dividend shall be set apart or paid on the common stock," and the court held that the preferred shareholders were entitled to share *pro rata* with the common stock in surplus profits in excess of the preferential dividend and a dividend at an equal rate per cent upon the common shares. The distribution of an eight per cent dividend among the common stockholders was, therefore, enjoined so far as related to the amount in

²⁴ 225 Pa. 279, 74 Atl. 166 (1909).

excess of five per cent. The fact that the common stock dividends had been eighteen per cent upon the amount actually paid in thereon was rejected as a practical interpretation by the parties on the ground that it was immaterial since these dividends amounted to but two per cent of the par value of said stock. In reaching its decision the court declared there was no ambiguity in the contract, and laid down the broad rule (p. 286) :

“Where there is no stipulation in the contract to the contrary, the weight of authority clearly favors the right of preferred stockholders to share with the common stockholders in all profits distributed, after the latter have received an amount equal to the stipulated dividend on the preferred stock.”

In view of the fact that at this time the entire “weight of authority” in the whole field of Anglo-American law was but its own decision in the *Fidelity Trust* case three years previously, opposed to which, as we have seen, was the strong *dictum* in *Scott v. Baltimore & Ohio R. Co.*, one is tempted to wonder whether this statement may not have been used as a judicial smoke-cloud. Probably the true explanation is that although the court cites only its own prior decision and the opinions of several text-writers for this new doctrine, it had in mind in using that expression the language of the treatises, a majority of which did support this doctrine.²⁵

Such was the condition of the law in 1912 when the question again came up in America—this time in the federal courts—and was also first presented for decision to the English judges. In the American case, *Niles v. Ludlow Valve Mfg. Co.*,²⁶ a New Jersey corporation, had an accumulated surplus of profits amounting to half a million dollars, and the preferred stock having been paid its stipulated preference dividends in full, the directors voted to distribute said surplus exclusively to the common stock, whereupon a preferred shareholder brought suit, claiming the right to participate equally with the common stock in said distribution after that stock had received an annual dividend equivalent to the preferred dividend. Under

²⁵ See notes 6 and 22, *supra*.

²⁶ 196 Fed. 994 (D. C., S. D., N. Y.) (1912).

the New Jersey corporation laws in force when the corporation was formed, the preferred stock was to be entitled "to a fixed yearly dividend" to be stated in the certificate of incorporation. In this instance the certificate of incorporation provided that the preferred shares should "receive interest or dividends of 8 per cent per annum and be²⁷ preferred as to capital as well as dividends," while the stock certificates simply stated an agreement to pay "to the holder of this stock a yearly dividend of 8 per cent. * * *". The United States District Court held that the preferred stock had no right to participate in the distribution of these accumulated surplus profits, but, on the contrary, that the entire amount belonged exclusively to the common stockholders.

This decision was affirmed in the Circuit Court of Appeals.²⁸ Both courts laid much stress upon the practical construction of the contract by the parties themselves as evincing their intention with regard to their respective rights as preferred and common stockholders. The evidence showed that for twenty years the corporation had paid the stipulated preferential dividend, and in nearly every year had also paid greater dividends to the common stock; that, in fact, for nine years the common dividend had been approximately double the preferred.

The *ratio decidendi* of the case was thus expressed by Coxe, J., in the Circuit Court of Appeals (p. 143):

²⁷ It has been sought to distinguish this case because of the presence of the word "interest" (I COOK ON CORPORATIONS [7th ed., 1913], Sec. 269, note 3), but as the statute merely referred to a "yearly dividend," the word seems to have no special significance. In New Jersey, Ohio, and several other states, however, the issue of preferred stock is assimilated to the making of a secured loan, thus: (a) the dividend rate may not exceed a prescribed maximum (eight per cent, which in Ohio is also the legal maximum for interest); (b) the amount of preferred stock which may be issued is limited and gauged like that of corporate bonds proportionately to the actual paid in capital (usually two-thirds); and (c) provision is made for redemption of preferred stock at par, with accrued dividend. This would seem to import a legislative recognition that the stipulated dividend per cent sets both a maximum and a minimum to the rights of the preferred stockholders in surplus profits. The point was not made in the principal case. N. J. GEN'L CORP. LAW, §§ 18, 149; OHIO GEN'L CODE, §§ 8667, 8668, 8669.

²⁸ 120 C. C. A. 319, 202 Fed. 141 (1913). Ward, J., dissented in favor of the second or Pennsylvania view.

"The common shareholders bear substantially all the losses of adversity and are entitled to the gains of prosperity. A contract that they should assume all the risk with no corresponding advantage should be clearly established. We find nothing in the law or the certificates or in the past action of the defendant (the corporation) to indicate that anyone connected with the business supposed that the preferred stockholders were to share equally with the common stockholders in the division of surplus earnings."

The English case, unique as one of the first impression in those long established courts, was that of *Will v. United Lankat Plantations Co., Ltd.*²⁹ By the articles of association the defendant corporation was authorized to issue preferred shares and to fix their preference or priority. Accordingly, the resolution authorizing the issue of the preferred stock provided that it should "be entitled to a cumulative preferential dividend at the rate of ten per cent per annum * * * and to rank both as regards capital and dividends in priority to the other shares." The company, which was chiefly engaged in tobacco cultivation in Sumatra, sold the rubber branch of its business for £30,000 and 45,000 fully paid shares of £1 each in a new company, and the stipulated preferred dividend having been paid in full, allotted the 45,000 shares to the common stockholders exclusively. A preferred stockholder began suit to have said distribution declared illegal, and to obtain a declaration that the preferred shares were entitled to rank for dividend *pari passu* in any profits of the company available for distribution after providing for the cumulative preferential dividend of ten per cent per annum and an equal dividend on the ordinary shares.

In the Chancery Division, Joyce, J., made the declaration sought, basing his decision upon his interpretation of a section of the articles of association which read:

"Subject to any priorities that may be given upon the issue of any new shares, the profits of the company available for distribution * * * shall be distributed as dividend among the members in accordance with the amounts paid on the shares held by them respectively."

²⁹ 106 L. T. Rep. (N. S.) 531.

The judge thus stated his position (p. 533) :

"In my opinion, when you look at the thing calmly and fairly, the right of priority given to the preference class is the right to be paid ten per cent, at least in respect of the current year, and in respect of past years, and subject to that right, the profits are to be divided amongst both classes according to the amount paid upon their shares."³⁰

Although pressed with the admitted fact that the preferred had never received more than the specified dividend, while much larger dividends had been from time to time paid on the ordinary shares, the court refused to consider that practical interpretation of their rights by the parties as material in the face of its own construction of the contract. In other words, the decision here was almost identical with the earlier Pennsylvania decision in the *Sternbergh* case, although that case was not cited to or by this court.

The Court of Appeals,³¹ however, unanimously reversed the Chancery Division, and expressly held, in accord with the third or mercantile view, that, in the absence of any provision to the contrary in the statute or contract under which the preferred shares were issued, they are entitled to their stipulated dividend only, and to no other share in the surplus profits, at least, while the corporation is a going concern. On appeal, the House of Lords unanimously affirmed this decision³² on the ground that, as a matter of interpretation of the Type II statute or contract, the third solution was correct and the second erroneous.

Thus, before the end of the year 1914 the practical view had overtaken the theoretical solution and wrested from it the weight of authority. Since then the second view has been twice reaffirmed in the state of its nativity—Pennsylvania³³—while the third method

³⁰ This language of the learned judge would support the first view, but his decision did not go that far.

³¹ [1912] 2 Ch. 571, 107 L. T. Rep. (N. S.) 360.

³² [1914] A. C. 11, 83 L. J. Ch. (N. S.) 195, 109 L. T. Rep. (N. S.) 754.

³³ *Stirling v. H. F. Watson Co.*, 241 Pa. 105, 88 Atl. 297 (1913). There the preferred stock was entitled to a cumulative semi-annual dividend of four per cent, and was subject to retirement upon payment of the par value and all arrears of dividends. The company undertook to retire the preferred stock by deducting from arrearages of dividends a twenty-five per cent stock

was approved and followed in 1917, in an unreported case, by a federal court sitting in that state,³⁴ and during the autumn of 1920 the Supreme Court of Maine added its support.³⁵

So much for the state of the authorities. Let us now consider

dividend which had been distributed equally to preferred and common, but the court held said dividend could not be charged against the back dividends as common and preferred, after each has received an equal dividend, have the "right to participate in the distribution of surplus earnings upon an equal basis."

In *Englander v. Osborne*, 261 Pa. 366, 104 Atl. 614 (1918), (also 6 A. L. R. 800 and note), the Pennsylvania court settled a doubtful point raised by the broad language of the rule laid down in the *Sternbergh* case, and not decided in the *Sterling* case, viz.: must the common stock, after payment of the preferred dividends in full, be paid past omitted dividends equal to all the preferred had received, or only that particular year's dividend to the same amount as the annual preferential dividend? It was held that the common shares were only entitled to an equivalent dividend for the current year and not to be reimbursed for unearned dividends in past years; therefore, the preferred stockholders were entitled to share *pro rata* with the common stock in all profits distributed after the latter have received in any year an amount equal to the stipulated dividend on the preferred stock. Notice this leaves open the question of the right of the common stockholders to profits in excess of the preferred dividend retained from year to year for depreciation, betterments and improvements. For a criticism of this case, see 3 MINN. LAW REV. 65 (Dec. 1918).

³⁴ *Keith v. Carbon Steel Co.* (U. S. D. C., W. D. Pa.), Orr, D. J. Opinion denying preliminary injunction filed April 30, 1917; opinion on final hearing filed August, 1917. In that case the holder of preferred non-cumulative six per cent stock, who had received the preference dividend in full, brought suit to restrain the corporation from paying accumulated earnings amounting to nearly one-half of its entire capital exclusively to the common stock, but the court rejected the Pennsylvania doctrine, and adopted the third view both as a matter of principle and upon authority of the *Niles* case and the English decisions.

³⁵ *Stone v. U. S. Envelope Co.*, — Me. —, 111 Atl. 536 (1920), Deasy, J. A common stockholder sought to restrain the corporation from distributing equally between the common and preferred shares a stock dividend representing an accumulated surplus of earnings which the directors in their discretion had retained and employed for betterments and improvements, claiming that as the preferred had been paid in full, its stipulated annual dividend of seven per cent, all remaining profits belonged solely to the common. The court upheld this contention, placing its decision expressly upon the third or mercantile doctrine. *Semble*: *Bassett v. U. S. Cast Iron & Foundry Co.*, 75 N. J. Eq. 539, 541, 73 Atl. 514 (1909).

the matter on principle. Which of the various criteria suggested should be accorded legal sanction, or rather, which of the conceivable solutions of this Type II phase of our problem best combines the support of legal principles, and adaptation to the actualities of the commercial field in which it is to operate, so that it most nearly attains actual justice in the concrete case?

We may summarily dismiss the first view, for, as pointed out, it has never found favor either in the courts or among business men. The question is thereby narrowed to an issue between our second and third suggested solutions.

The Pennsylvania or second criterion is based upon the very plausible argument of many text-writers that "a share of stock is a share of stock, whether preferred or common."³⁶ The underlying theory is that since in the simple corporate situation with one class of stock all shares are equal, classification of the stock into preferred and common does not displace this basic equality, but to the extent of the preference amplifies the rights of the preferred stock, therefore, in the absence of distinctly restrictive provisions, the preferred stockholders possess all the rights of common stockholders, and in addition their own special advantages.³⁷ We find this idea well expressed in the dissenting opinion of Ward, J., in *Niles v. Ludlow Valve Mfg. Co.*,³⁸ (p. 144) :

"The general principle is that all stockholders share equally in net profits, except as their relations are altered by statute or contract. If a preference is given to one class of stockholders over the rest, it should be construed consistently with this general principle as far as possible. For instance, if the preferred stockholders are given the right to receive a dividend of a fixed amount before the common stockholders get anything, the latter should next receive an equal amount, and then the surplus, if any, be equally divided between the preferred and common stockholders. Where the privilege is

³⁶ See I COOK ON CORPORATIONS [5th ed., 1902, and subsequent editions], Sec. 269, where the learned author in a footnote advocates this as the theoretically and logically correct principle, in spite of the mercantile view to the contrary. This view seems to be fundamentally a syllogism.

³⁷ *Sternbergh v. Brock*, and other Pennsylvania cases (*supra*).

³⁸ In U. S. Circuit Court of Appeals, 2nd Circuit, 202 Fed. 141 (1913).

intended to be restrictive, the intention should be expressed, as by saying that the preferred stockholders are to be paid a certain dividend before the common stockholders get anything, and are to receive nothing more."

There is also somewhat of legal analogy in support of this view.³⁹ For example, although apparently not called to the attention of the Pennsylvania court, the basic principle of its doctrine had been previously enunciated and applied by the courts in the closely analogous situation of the respective rights of stockholders, whether preferred or deferred as to profits, to share in a distribution of capital. In the leading case of *Jones v. Concord & Montreal R. R.*,⁴⁰ Doe, C. J., relying upon the simple concept that a share of stock is a share of stock, no matter what adjective is attached to it, allowed all classifications of stock to share *pro rata* in a stock dividend distributing a capital surplus.⁴¹

This fundamental premise of the equality of corporate shares, which constitutes the heart and substance of the second view, was accepted by the text-writers generally and by the Pennsylvania Supreme Court as axiomatic,⁴² but in the later case of *Will v. United Lankat Plantation Co., Ltd.*,⁴³ the English judges vigorously

³⁹ One naturally thinks of the oft-repeated statements of the text-writers that where stock is given a preferential dividend, nothing being said as to whether it is to be cumulative or non-cumulative, it shall be deemed to be cumulative, and that preferred stock, in the absence of provision to the contrary, possesses equal voting power with the common, but the cases do not bear out this broad phraseology.

⁴⁰ 67 N. H. 119 (1891), and other cases cited in note 7, *supra*.

⁴¹ It should be noted, however, that on a rehearing (67 N. H. 234) (1892) the court (Isaac Smith, J.) specifically distinguished our problem, pointing out (p. 241) that it did not appear what the corporation had earned, or what division had been made of its earnings; therefore, "The facts stated in the case do not show that the proposed issue of new stock is a dividend of earnings (belonging to different classes of stockholders), or a violation of any provision of the contract of union (under which the various shares were issued) relating to dividends." Also, In re Bridgewater Navigation Co., [1891] 2 Ch. 317, where profits reserved for depreciation and similar purposes were given exclusively to the ordinary shareholders and not distributed *pro rata* to the preferred shares on the winding up of the company as were the capital assets.

⁴² See note 36, *supra*.

⁴³ See note 32, *supra*.

denounced this hypothesis as untrue. Speaking on this point in the House of Lords, Viscount Haldane, Lord Chancellor, said (p. 17) :

"I think that Lord Justice Farwell called attention to what is really a cardinal consideration in this matter. Shares are not issued in the abstract and priorities then attached to them; the issue of shares and the attachment of priorities proceed *uno flatu*; and when you turn to the terms on which the shares are issued you expect to find all the rights as regards dividends specified in the terms of the issue. And when you do find these things prescribed it certainly appears to me unnatural to go beyond them, and look to the general provisions of an article which is only to apply if nothing different is said" (i. e., no priorities specified).

The third solution has been adopted by other courts as an exception to the general principle of equality of shares. For instance, in the very latest case⁴⁴ the Maine Supreme Court said :

"We put the decision, however, upon the ground that, where nothing to the contrary appears, the creation of preferred stock *prima facie* implies that the preferential rights of the stockholder are given in lieu of and to the exclusion of the equality in participation which would otherwise exist."

The maxim, "*Expressio unius est exclusio alterius*,"⁴⁵ is frequently made the basis for the third solution. The reasons which lead the courts to resort to this old maxim on the point before us are well stated by Orr, D. J., in *Keith v. Carbon Steel Co.*,⁴⁶ where, in denying to a preferred stockholder who had been paid in full a preliminary injunction restraining distribution of all remaining profits to the common stock, he said :

"The holders of the preferred stock must be deemed to have been unwilling to take the same risks as the holders of the common stock were willing to take. In other words, they were not willing to take their certificates without an expres-

⁴⁴ *Stone v. U. S. Envelope Co.*, — Me. —, 111 Atl. 536 (1920).

⁴⁵ *BROOM'S LEGAL MAXIMS*, p. 651.

⁴⁶ See note 34, *supra*.

sion therein of the amount which they were entitled, respectively, to receive out of the profits. * * * We are unable to see why, in contracts such as these before us, the *expression* of the amount to be received under the contract should not be deemed to be an exclusion from the minds of the parties of any additional amount. * * * A certificate of stock does not ordinarily *express* the share of profits which a stockholder shall receive from the corporation, and therefore the law *implies* a term in the agreement that the holder of such certificates shall share equally in the profits set apart by the management for the payment of dividends. There can be no implication, however, where the contract expressly states the percentage which the one contracting party is to receive from another."⁴⁷

The courts adopting the third view have also relied much upon the long-established canon of construction that in the interpretation of obscure statutes and contracts the legislature or the parties, as the case may be, must be presumed to intend that which is reasonable under the circumstances.⁴⁸ Applying this reasonable construction to our specific question, these courts argue that it is highly unreasonable that the common stock should bear substantially all

"When you find—as you find here—the word 'dividend' used in the way in which the expression is used in the resolution and defined to be 'a cumulative preferential dividend,' you have something so definitely pointed to as to suggest that it contains the whole of what a shareholder is to look to from the company." Viscount Haldane, L. C., in *Will v. United Lankat Plantation Co., Ltd.*, [1914] A. C. 11, 18.

In *Stone v. U. S. Envelope Co.*, — Me. —, 111 Atl. 536, 537 (1920), Deasy, J.: "The maxim, '*Expressio unius*,' etc., applies to this case and is decisive. The parties by a contract embodied in the by-laws have provided for the preferred stockholders a seven per cent preferential dividend and in case of liquidation one hundred per cent. This excludes other participation."

Cf. In re *National Telephone Co.*, [1914] 1 Ch. 755, holding where the preferred stock was expressly given a priority in repayment of assets on a winding up, that was *prima facie* a definition of the whole of their rights in this respect; therefore, they could not share with the common in the distribution of surplus assets.

⁴⁸ I BLACKSTONE'S COMMENTARIES 61, concerning the interpretation of laws, subdiv. 5.

the losses of the lean years and let the protected preferred stock enjoy *pro rata* the results of the prosperous years; that "a contract they should assume all the risk with no corresponding advantage should be clearly established."⁴⁹ The *de facto* basis of this reasoning is thus pointed out by Orr, J.:⁵⁰

"It is a matter of common experience that at the inception of the business of a corporation the returns from such business will be uncertain. Because there may not be sufficient earnings which may be distributed to all the stock, yet sufficient for part thereof, classifications of such stock are undertaken to induce subscriptions to the capital stock. Investors who desire more certainty with respect to their returns are more inclined to subscribe for shares which are preferred over other shares in the distribution of earnings. Those stockholders who are content that those who desire immediate returns should have the preferred stock, and who themselves are willing to wait until the earnings become great enough to give them proper returns, are content to take common stock. It is not reasonable to suppose that the common stockholders would at once have the same share in the earnings as the preferred stockholders, and it is not reasonable to suppose it was ever contemplated that they should, because the holders of the preferred stock have stipulated for the amount of dividend that they should receive. The classification of the stock of defendant company was by the shareholders. * * *

The learned judge concludes by quoting the statement of Coxe, J., in *Niles v. Ludlow Valve Mfg. Co.*, that "The common stockholders bear substantially all the losses of adversity and are entitled to the gains of prosperity."

While the result of *Will v. United Lankat Plantations Co., Ltd.*,⁵¹ was the rejection of the second view and the definite adoption of the third solution by the courts of England, yet there is a most sig-

⁴⁹ Coxe, J., in *Niles v. Ludlow Valve Mfg. Co.*, 202 Fed. 141, at 143.

⁵⁰ See note 34, *supra*.

⁵¹ See notes 31 and 32, *supra*.

nificant distinction between the *ratio decidendi* of that case in the Court of Appeal and in the House of Lords.

The opinions of the Lords make no mention of the mercantile view as such, but they join issue with the second solution upon its own footing as a matter of theoretical and logical construction of the contract. This is illustrated by Viscount Haldane's declaration (p. 17):

"You do not look outside a document of this kind in order to see what the bargain is; you look for it as contained within the four corners of the document."

Thus stated, the essential difference between the second and third solutions, as a matter of pure interpretation, seems to lie in the truth of the hypotheses upon which the respective views are based—that in the absence of express provision one way or the other, diversified classes of stock are born equal, or are in their very creation subject to preferences or limitations.

In other words, the House of Lords and the Pennsylvania court have this in common: they agree that the contract is not ambiguous; hence it is to be interpreted within its four corners; and they arrive at this conclusion of non-ambiguity simply because each tribunal assumes the infallibility of its own hypothesis.⁵² But it should be noted that each hypothesis is essentially one of fact. Then how are we to determine whether this assumption of fact is true or not? Surely by testing it with the reality; yet that is precisely what both these courts refuse to do, for by their assumption of non-ambiguity in the contract they render inadmissible extrinsic evidence of the actualities of the business world, since, theoretically, there remains nothing doubtful requiring explanation, and this in spite of the fact that the parties have left utterly unprovided for the very situation in issue.⁵³

⁵² This is an excellent illustration of our lagging science of law as pointed out by Dean Pound: "Today, while other sciences, in the wake of the natural sciences, have abandoned deduction from pre-determined conceptions, such is still the accepted method of jurisprudence." *Law in Books and Law in Action*, 44 AM. LAW REVIEW 12, 25 (1910).

⁵³ As Dean Pound has said, "Turn where one will, in matters of the very first importance to the commercial world, the law of business corporations, the law of partnership, restrictive agreements upon the sale of chattels—in

In each instance "the postulates are taken for granted upon authority, without inquiry into their worth, and then logic is used as the only tool to develop the results."⁵⁴ Here the authority relied upon by the Pennsylvania court was the general opinion of the text-writers, while the House of Lords pretends to rely upon its judicial knowledge.⁵⁵

To the harassed business man the opinion of these courts must appear merely another exasperating example of the unfathomable technicality of the law—a scholastic indifference to the pressing actualities of the market-place. This is the very attitude of the judiciary which Justice Holmes so pointedly criticized:

"We must think things, not words, or at least we must constantly translate our thoughts into the facts for which they stand, if we are to keep to the real and true."⁵⁶

On the other hand, our business man would find no difficulty in comprehending the opinion of the Court of Appeal in the *Will* case,⁵⁷ for that takes cognizance of matters within his experience and environment, and expressly adopts the mercantile view. Note the pragmatic viewpoint as there set forth by the Master of the Rolls (Cozens-Hardy) (at p. 576):

"What is the ordinary *prima facie* meaning of preference shares having a fixed dividend, fixed in this sense that it does not vary with the profits of the year, but is a fixed dividend of 10 per cent per annum. It seems to me that the ordinary meaning is that the resolution defines and limits the dividend

all these cases we see precisely the same refusal to look at the situation of fact in the actual world, the same insistence upon the self-sufficiency of abstract legal conceptions, the same logical development of the traditional doctrine at all cost." Address before the Commercial Law League, July 26, 1917. 28 AM. LEGAL NEWS, October, 1917; Commercial Law League of America, Bulletin 1, XXII (1917) 608.

⁵⁴ Holmes, J., "Law in Science and Science in Law," 12 HARVARD LAW REVIEW 443, 460. Reprinted in Holmes, "COLLECTED LEGAL PAPERS" (1920).

⁵⁵ The Lords cited no authority for their premise, but seem to have adopted it *a priori*.

⁵⁶ See note 54, *supra*.

⁵⁷ See note 31, *supra*.

which a preference shareholder can take. I accept and adopt the observation of a living writer whose experience in this matter is very great (PALMER'S COMPANY PRECEDENTS [11th Edit.], p. 814): 'It is generally assumed that where the preference shares are given a fixed preferential dividend at a specified rate that impliedly negatives any right to take any further dividend, and probably this assumption is well founded.' In my opinion, that assumption is well founded. * * * One cannot be aware to any extent of what goes on on the stock exchange without knowing that preferential shares and stock are ordinarily spoken of and regarded, and I think properly regarded, as shares of stock which carry a fixed preferential dividend, and are not entitled to anything more."

After all, is this not primarily a business man's problem, the very kind of matter that was dealt with in early English law in the extra-legal mercantile courts,⁵⁸ and for which Lord Mansfield devised his famous merchant jury? The actuality is that we have here a business man's contract of a type commonly made and dealt with in the ordinary course of mercantile transactions, a contract known to and interpreted by the business world for generations without once seeking the aid of the courts—clear evidence that it was founded on a well-established law merchant. During all that time, too, the general business understanding of the respective rights of the classes of stockholders mentioned was daily published broadcast in the stock exchange quotations, where the common shares of a successful corporation always commanded a premium over the preferred.

Notice the remark of Earl Loreburn in the *Will* case⁵⁹ (p. 19):

"My Lords, I have no doubt myself, in regard to this particular resolution, that the people who took the preference shares under it knew perfectly well that they were taking shares with a preferential dividend of 10 per cent. I think they would have been rather surprised, although no doubt they would have been gratified, if they had been told that

⁵⁸ I POLLOCK AND MAITLAND, HISTORY OF THE ENGLISH LAW [2nd ed., 1899], p. 465.

⁵⁹ See note 32, *supra*.

they were about to receive the almost boundless additional advantages which have been held out to them in the arguments we have been hearing."

But why did they not expect it. There is just one answer, since the contract, it must be remembered, is silent on the subject: they knew that by the established law merchant they were not entitled to more than the stipulated preference.

Truly, we must revamp our legal conceptions by the old maxim of the civilians, *ex facto oritur jus*, recognizing that to have a living law it must grow in harmony with the *de facto* situation.⁶⁰ Viewed in this way, how much more scientific, in the sense of that which is simple and in accord with the actualities, is the frank avowal of the prevailing law merchant by the English Court of Appeal than the artificial reasoning of the House of Lords⁶¹ and the Pennsylvania court. It faces the realities of the problem, and simply adopts the law merchant to give effect to what must have been the true, but unexpressed, intent of the parties,—business men familiar with the mercantile understanding, and, therefore, presumably dealing with that established interpretation of such contracts in mind.⁶²

This triumph of the third or mercantile solution of the Type II case was no mere accident, but probably our most complete example of wholly twentieth century-made law. True to the master juristic thought of the time this commercial usage became a rule of law, not merely because it fitted well into established legal principles, but

⁶⁰ Speaking of this maxim, "Justice Brandeis says: "It [the court] realized that no law, written or unwritten, can be understood without a full knowledge of the facts out of which it arises, and to which it is to be applied." "The Living Law," 10 ILL. LAW REVIEW, 461, 467 (1916).

⁶¹ The House of Lords seems to reach the correct result here by the anomalous method of adhering to "case-knife" terminology while administering "pick-axe" justice, as Dean Pound expresses it in the words of Tom Sawyer and Huck Finn. "Law in Books and Law in Action," 44 AM. LAW REVIEW 12 (1910).

⁶² The legal consequence of the now dominant third view seems to be the standardizing of the preferred stock contract, Type II, and the creation of a new status—that of a preferred stockholder whose rights are fixed by reason of his position; another step in the modern reaction of the pendulum of the law from contract to status, suggested by Nathan Isaacs, "Standardizing of Contracts," 27 YALE LAW JOURNAL 34, 37 (1917).

chiefly for the reason that, being itself the product of the actualities of the field in which it was to operate, it promised best to function for real justice in the every-day life of the community.⁶³

GEORGE JARVIS THOMPSON.

University of Pittsburgh Law School.

⁶³ "Perhaps the most significant advance in the modern science of law is the change from the analytical to the functional standpoint. For the jurist of today, the world over, seeks to discover and to ponder the actual social effects of legal institutions and legal doctrines. * * * Men no longer think in closed systems nor seek to foreclose change by rigid postulates from which all details are to be inevitable logical deductions." Dean Pound, "Anachronisms in Law," address delivered before the Conference of the Bar Association Delegates, at the 1917 meeting of the American Bar Association. 3 JR. AM. JUD. SOC. 142.